



DEFENSE CONTRACT AUDIT AGENCY
DEPARTMENT OF DEFENSE
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IN REPLY REFER TO

PAC 730.3.B.08/2003-08

February 20, 2004
04-PAC-013(R)

MEMORANDUM FOR REGIONAL DIRECTORS, DCAA
DIRECTOR, FIELD DETACHMENT, DCAA

SUBJECT: Audit Guidance on Projected Pension Costs and Full Funding Advance Agreements

Summary

This memorandum transmits recent DCMA guidance on Contractor Pension Costs and Full Funding Agreements; withdraws current guidance in CAM 7-606 which advises auditors to question pension costs in forward pricing actions if a contractor refuses to enter into a full funding advance agreement when its plan is fully funded or there is a potential for the plan to become fully funded; and provides additional guidance on auditing projected pension costs in forward pricing actions.

Auditors should request the assistance of the DCMA pension specialist in the review of the contractor's projected pension costs when those costs have a material impact on forward pricing rates, especially when the pension plan is at or near full funding status. Projected pension costs should not be questioned due to the absence of a full funding advance agreement if the auditor, in coordination with the DCMA pension specialist, determines that the projected pension costs are reasonable and not otherwise unallowable. Projected pension costs resulting from the use of a rate of return on assets less than the contractor's assumed long-term rate of return should be questioned.

Background

On March 31, 2003, we issued MRD 03-PAC-026(R), Audit Guidance on Contractor Pension Plans Coming Out of Full-Funding, reminding auditors to follow the guidance in CAM 7-606, Advance Agreements for Pension Plan Costs, and in particular CAM 7-606.2, Full Funding Limitation Advance Agreements. CAM 7-606.2d advises auditors to question pension costs in forward pricing actions if a contractor refuses to enter into a full funding advance agreement when its plan is fully funded or there is a potential for the plan to become fully funded. That CAM guidance is based on a September 17, 1986 OSD guidance memorandum calling for the negotiation of advance agreements that provide for the Government to receive a credit when pension costs priced into fixed-price contracts are not incurred due to funding limitations. On October 6, 2003, DCMA issued Information Memorandum No. 04-007, Contractor Pension Costs and Full Funding Agreements (Enclosure). In summary that memorandum provides that:

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- ✓ The September 17, 1986 OSD guidance memorandum is no longer in effect.
- ✓ DCMA generally discourages the use of full funding advance agreements.
- ✓ A policy change would be issued requiring that any such agreements be reviewed by general counsel and submitted to a DCMA Headquarters Board of Review.
- ✓ If negotiations of cost-based, firm-fixed-price contracts are inhibited due to pension uncertainties, ACOs should consider recommending reopener clauses to the buying activity customer.

Guidance

In light of the recent DCMA guidance on full funding advance agreements, and the fact that the 1986 OSD guidance upon which current applicable DCAA guidance is based is no longer in effect, we are issuing the following revised guidance.

Auditors should request the assistance of the DCMA pension specialist in the review of the contractor's projected pension costs when those costs have a material impact on forward pricing rates, especially when the pension plan is at or near full funding status. Projected pension costs should not be questioned due to the absence of a full funding advance agreement when the contractor's pension plan is at or near full funding status, if the auditor, in coordination with the DCMA pension specialist, determines that the projected pension costs are reasonable and not otherwise unallowable.

Since volatility in the equity and bond markets makes predicting the actual rate of return on assets speculative at best, the contractor should use its assumed long-term rate of return in estimating the pension plan's return on assets when projecting pension costs for forward pricing purposes. In addition, in determining if the projected pension costs will be limited by the assignable cost limitation (i.e., if the actuarial value of assets exceeds the accrued actuarial liability plus current normal costs), the contractor should also estimate the actuarial value of assets using the contractor's assumed long-term rate of return. Given the speculative nature of predicting investment returns, we believe that the contractor's assumed long-term rate of return would be the best available estimate of the actual rate of return on assets. Accordingly, projected pension costs resulting from the use of a rate of return on assets less than the contractor's assumed long-term rate of return should be questioned.

Audit reports on forwarding pricing actions (i.e., forward pricing rates or individual price proposals) that include projected pension costs for contractor pension plans at or near full funding status, should provide sufficient information for the reader to understand the risk associated with such circumstances. This information should be included as a part of the explanatory notes. If there are no audit findings and the usual exhibits, schedules and explanatory notes are omitted, this information should be included as a part of the results of audit section, after the audit opinion. An example of language that could be included in audit reports on forward pricing rates follows and should be tailored to the specific circumstances:

This audit report incorporates the results of the DCMA CIPR Center technical evaluation. The technical evaluation took no exception to the proposed pension costs. That evaluation assumes that pension plan assets will earn at a rate of return equal to the plan's assumed long-term

valuation interest rate. The contractor's pension plan is currently at or near full funding status (i.e., current pension plan liabilities and the actuarial value of plan assets are nearly equal). Based on the assumed long-term rate of return on pension plan assets, the plan is projected to be underfunded for the entire forecasted period [*or some of the forecasted accounting periods*]. However, given the current volatility in the stock market, the possibility exists that the actual rate of return on plan assets could exceed the assumed long-term valuation interest rate, in which case the pension plan may be fully funded during the forecasted period. If the pension plan is fully funded in any given year, the pension costs projected for that year will not materialize, resulting in a windfall profit to the contractor on fixed-price contracts. We recommend that the contracting officer consider these facts during negotiations.

The above language (tailored to the specific circumstances) should also be included in audit reports on individual price proposals for fixed-price contracts when a forward pricing rate agreement has not been executed and the proposed pension costs are significant enough to impact the indirect rates if the pension costs are not incurred. The paragraph should be expanded to include information regarding the impact on the contractor's proposal if the pension costs are not incurred. For example, a comparison may be included of the proposed indirect rates, adjusted for any audit exceptions, to what those rates would be if the projected pension costs are not incurred. (Only rates that would be materially impacted by pension costs should be included.) The auditor should consider the circumstances unique to each individual price proposal and the contractor's rate structure in determining how much information to provide and in what format. The point is to provide the contracting officer with sufficient information to clearly understand the potential impact on the negotiated price should the proposed pension costs not be incurred.

If FAO personnel have any questions, they should contact regional personnel. If regional personnel have any questions, they should contact Ms. Anita Homburg, Program Manager, Accounting and Cost Principles Division, at (703) 767-3250 or DCAA-PAC@dcaa.mil.

/s/ Terry M. Schneider
/for/ Robert DiMucci
Assistant Director
Policy and Plans

Enclosure:

DCMA Information Memorandum No. 04-007, Contractor Pension Costs and Full Funding Agreements, October 6, 2003

DISTRIBUTION: C

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Information Memorandum No. 04-007

Subject: Contractor Pension Costs and Full Funding Agreements (INFORMATION)

Date: October 6, 2003

Target Audience: DCMA CACOs, DACOs and ACOs involved with Contractor Pension Costs

New Information/Guidance/Tools:

- Information Memorandum No. 03-213 referenced DCAA guidance issued on March 31, 2003 concerning contractor pension plans coming out of full funding. The DCAA guidance instructs auditors to follow Contract Audit Manual (CAM) 7-606.2, Full Funding Advance Agreements.
- A basis for issuing the CAM 7-606.2 guidance was an OSD memorandum issued by the Office of Acquisition and Logistics DASD(P) (CPF) on September 17, 1986. The memorandum stated in part that, pending issuance of revised Cost Accounting Standards regulations, an advance agreement to require retroactive downward adjustments to contract prices when the contractor pension plan moved into a surplus situation should be executed. Since the Cost Accounting Standards regulation revisions mentioned in the memorandum have been made, the memorandum is no longer in effect. The Office of Defense Procurement and Acquisition Policy concurs.
- We generally discourage the use of any full funding advance agreements. Consequently, we will be issuing a policy change to require that any proposed full funding agreement be reviewed by general counsel and submitted to a Headquarters Board of Review prior to their execution with the contractor.
- If one of your buying activity customers is unable to negotiate a "cost-based" firm-fixed-priced contract because of pension uncertainties, you should consider recommending that they include a reopener clause in the specific contract. This would normally be a more practical alternative than negotiating a full funding agreement.

Point of Contact for Further Information:

HQ: Patrick Ring, DCMA-OCB, (703) 428-1010

Signature:

DAVE RICCI, DIRECTOR, CONTRACT BUSINESS OPERATIONS

Enclosure